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**REVISITING LATENT DEFECTS;
A PAINFUL WALK DOWN MEMORY LANE**

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On February 12, 1998, the Florida Supreme Court resolved a long standing conflict between two district courts of appeal regarding a surety's liability under a performance bond for latent or hidden construction defects.

In Federal Insurance Company v. Southwest Florida Retirement Center, 707 So.2d 1119 (Fla. 1998), the Florida Supreme Court held that a surety may be liable under a performance bond for defective work performed by its principal contractor regardless of whether the defect is discovered before or after substantial completion of the project. In its decision, the Florida Supreme Court also set a significant precedent regarding the accrual date of the statute of limitations on claims against a surety.

This paper analyses the reasoning used by the Florida Supreme Court in Federal Insurance in resolving the latent defects conflict and the benefits provided to the surety under the statute of limitations as applied by the Florida Supreme Court.

HISTORICAL BACKGROUND

In Florida Board of Regents v. Fidelity & Deposit Co. of Maryland, 416 So.2d 30 (Fla. 5th DCA. 1982), the owner filed suit against the surety seeking damages under a construction performance bond for alleged latent defects. By affirming the trial court's summary judgment in favor of the surety, the Fifth District Court of Appeal held that the performance bond did not insure against the latent or hidden defect risks described in the suit. According to the Fifth District, the performance bond at issue in Fidelity & Deposit merely assured completion of the building by the bonded contractor. The Fifth District reasoned that:

The [Owner] claims there were latent defects in the materials and workmanship which were discovered after the architect had certified substantial completion and after the statute of limitations had run. The [Owner] contends that [Fidelity & Deposit Company of Maryland], the surety under the performance bond, is liable for payment because of those defects. We disagree. Once the building is completed, or as we have said using the words of art in the construction industry, "substantially completed" then the surety under the performance bond is relieved of any further responsibility. The purpose of a performance bond is to insure the physical completion of the work upon default. . . and to insure against any losses which the owner may suffer if performance default occurs.

416 So.2d at 32.

The decision in Fidelity & Deposit was widely criticized by construction lawyers representing government owners and private developers. Obviously, bonding companies and surety lawyers were thrilled at the possibility of having a benchmark date (substantial completion) beyond which the surety would not be liable for construction defects. However,

shortly after the decision in Fidelity & Deposit, the Second District Court of Appeal reached a different conclusion in School Board of Pinellas County v. St. Paul Fire Marine Ins. Co., 449 So.2d 872 (Fla. 2nd DCA 1984).

In St. Paul Fire Marine, the School Board filed suit against the general contractor and its surety seeking damages for latent defects appearing two years after the building had been completed. Relying on the Fifth District's decision in Fidelity & Deposit, the trial court concluded that the performance bond did not cover the latent defect claims asserted by the School Board once the School Board had accepted the completed building. Accordingly, the trial court entered summary judgment in favor of St. Paul Fire & Marine on the performance bond.

On appeal, the Second District Court of Appeals reversed the trial court's decision and held that the performance bond must be interpreted in conjunction with the prime contract between the general contractor and the School Board. Because the performance bond required the contractor to "promptly and faithfully perform said contract," the Second District held that the surety may be liable for the contractor's breach of a contractual provision. According to the Second District:

If the School Board can establish that [the Contractor] breached its contract by failing to construct the building in accordance with the plans and specifications, that [the School Board] was unaware of those defects at the time of its acceptance, and, that such defects were not apparent under reasonable inspection, then St. Paul may be held liable for such latent defects to the same extent that [the Contractor] is liable therefor.

449 So.2d at 874.

For several years, most legal practitioners realistically viewed the Second District's decision in St. Paul Fire Marine to be more in line with the surety's exposure in other jurisdictions. See City of Seaside v. Randalls, 180 Pac. 319 (Oregon 1919); Salem Realty Company, Inc. v. Batson, 123 S.E. 2d 744 (N.C. 1962); Mason v. City of Albertville, 158 So.2d 954 (Ala. 1963); Hayward County Consolidated School System v. United States Fidelity & Guaranty Company, 257 S.E.2d 670 (N.C. Ct. App. 1979); Congregation of St. Peter's Roman Catholic Church of Gueydan v. Simon, 497 So.2d 409 (La. 3rd Cir. 1986).

However, in 1992, the Florida Supreme Court decided American Home Assurance Co. v. Larkin General Hospital, 593 So.2d 195 (Fla. 1992). In Larkin, the issue before the court was whether a surety on a performance bond could be held liable for consequential delay damages caused by the general contractor's default. The Florida Supreme Court held that a surety could not be held liable for delay damages due to the contractor's default unless the language of the performance bond specifically provided coverage for delay damages. This decision in Larkin energized the surety bar to push the envelope with more persuasive arguments to eliminate a surety's liability for certain damages which are not specifically

addressed in the language of performance bonds. As discussed below, the surety in the Federal Insurance case made an excellent, though unsuccessful, attempt at eliminating liability for latent defects based on the decision in Larkin.

THE SUPREME COURT'S DECISION IN FEDERAL INSURANCE

In Federal Insurance, the owner hired a general contractor McCarthy Construction to build a new retirement center. Federal Insurance Company executed and delivered a performance bond to the owner utilizing a standard AIA Document A311 (1970). This performance bond incorporated by reference the construction contract executed by McCarthy and guaranteed the faithful performance of the construction contract according to its terms and conditions. McCarthy completed construction of the retirement center in 1984. Ten years later, the owner filed suit against McCarthy and its surety claiming a breach by McCarthy of its express warranty obligations under the construction contract.

The trial court entered a judgment on the pleadings in favor of the surety holding that the claim against the performance bond was time-barred by the applicable statute of limitations. According to the trial court, Section 95.11(2)(b), Florida Statutes, provides a five-year limitation that results in an absolute bar in any action against a surety for latent defects discovered beyond the five-year period, beginning with the acceptance of completion of the building. See also School Board of Volusia County v. Fidelity Co. of Maryland, 468 So.2d 431 (Fla. 5th DCA 1985). Because the claim was filed by the owner beyond the five-year timeframe, the surety was relieved of any liability under the performance bond.

On appeal, the Second District Court of Appeals reiterated its position in St. Paul Fire Marine by implicitly rejecting the surety's position that no liability existed for defects appearing after substantial completion. In its opinion, the Second District also agreed that the five-year contract limitation period under Section 95.11(2)(b), Florida Statutes, applied to claims against the surety on the performance bond.

However, the Second District Court of Appeals reversed the trial court's decision to absolutely bar claims against the surety after five years of building completion. On the contrary, the court held that the five-year limitation period against the surety must be read in conjunction with the statute of limitations applicable to claims against the general contractor under 95.11(3)(c), Florida Statutes. This statute was interpreted to provide that actions against the general contractor shall be commenced within four (4) years for:

An action founded on the design, planning, or construction of an improvement to real property, with the time running from the date of actual possession by the owner, the date of the issuance of a certificate of occupancy, the date of abandonment of construction if not completed, or the date of completion or termination of the contract between the professional engineer, registered architect, or licensed contractor and his or her employer, whichever date is latest; except that, when the action involves a latent defect, the time runs from the time the defect is discovered or should have been discovered with the exercise of due diligence. In any event,

the action must be commenced within 15 years after the date of actual possession by the owner, the date of the issuance of a certificate of occupancy, the date of abandonment of construction if not completed, or the date of completion or termination of the contract between the professional engineer, registered architect, or licensed contractor and his or her employer, whichever date is latest.

Because the Second District Court of Appeals concluded that the performance bond and the general contractor's agreement were co-extensive, the court held that the five-year limitations period for an action against the surety did not begin to run until the owner's discovery of the latent defect constituting the contractor's breach of warranty.

In a dissenting opinion, Judge Blue criticized the Second District's unauthorized "tolling" of the statute of limitations on the surety's claim and argued against any linkage between the surety's limitation and the tolling provisions contained in the "latent defect" statute applicable to general contractors. In his dissent, which was ultimately adopted in part by the Florida Supreme Court in Federal Insurance, Judge Blue wrote:

The majority opinion makes the claim against the bonding company actionable more than ten years after completion of the bonded construction. It does this by explaining that the cause of action does not accrue until the latent defect is discovered and only then does the five-year statute of limitations begin to run. This analysis purely and simply attaches a tolling period to the statute of limitations applicable to the bond. It is the tolling provision in section 95.11(3)(c) which permits a cause of action beyond the four-year limitations period in this section. To make the latent defects actionable against the bonding company requires imposing a tolling period within section 95.11(2)(b), which School Board of Volusia County and this court have held is a legislative determination.

707 So.2d at 1120; See also School Board of Volusia County v. Fidelity Co. of Maryland, 468 So.2d 431 (Fla. 5th DCA 1985).

The Florida Supreme Court in Federal Insurance began its analysis by addressing the threshold issue of whether the surety could be liable under the performance bond for latent defects discovered after substantial completion. As the Court observed, if there is no liability for latent defects then the statute of limitations applicable to the surety would be irrelevant.

Initially, the surety in Federal Insurance argued that the Florida Supreme Court's decision in Larkin should be extended to prohibit any liability of a performance bond surety for latent defects discovered after substantial completion. As addressed earlier, the court in Larkin held that a surety could not be held liable for delay damages due to the contractor's default unless the performance bond specifically provided coverage for delay damages. Because the bond in Federal Insurance did not specifically address latent defects, the surety insisted that the court should not judicially rewrite the terms of the performance bond to

include coverage for such risks. The Florida Supreme Court disagreed with the surety and declined to extend Larkin beyond claims for delay damages.

According to the Florida Supreme Court, the intent of a performance bond is to guarantee that the financial responsibility of the surety stands behind the general contractor's completion obligations under the prime contract. The Florida Supreme Court held:

Federal's promise that the project would be completed according to the terms and conditions of the construction contract means that Federal would be liable for defective work performed by the general contractor upon the general contractor's default. This liability is not dependent upon whether the defect was discovered before or after substantial completion. . . . We find no logical reason to distinguish between patent defects and latent defects in respect to the coverage of the performance bond. We reject the decision of the Fifth District in Florida Board of Regents v. Fidelity & Deposit Co. of Maryland, 416 So.2d 30 (Fla. 5th DCA 1982), to the extent that decision holds that when a construction contract is substantially completed the surety is relieved of any further responsibility.

707 So.2d at 1121.

Having disposed of the threshold question regarding bond coverage for latent defects, the Court turned its attentions to the applicable statute of limitations. Again, the surety argued that the Second District erred in linking the "tolling" provisions of the contractor's statute of limitations (Section 95.11(3)(c), Florida Statutes) to the surety's five-year limitation under Section 95.11(2)(b), Florida Statutes. The Florida Supreme Court held that:

We do not agree with the district court's majority that the five-year period would begin to accrue at a time other than acceptance of the construction. On this issue we agree with Judge Blue's dissent and quash the majority's decision. We expressly hold that Section 95.11(2)(b), Florida Statutes (1981), as it applies to an action on a performance bond, accrues on the date of acceptance of the project as having been completed according to terms and conditions set out in the construction contract.

707 So.2d at 1121.

Although the owner argued strenuously that its cause of action was based on the surety's breach of its obligations to cure the contractor's default, the Florida Supreme Court rejected this position. The owner reasoned that the surety's obligation to cure was continuing and that, because the surety was not called upon to cure the default until ten years after completion, the statute of limitations did not begin to run against the surety until notice of the default.

CONCLUSION

Although it is helpful that the Florida Supreme Court in Federal Insurance clarified the surety's exposure for latent defects, its application of the statute of limitations is of great significance. Federal Insurance opens the door for "unlinking" the surety's liability and the contractor's liability depending upon the specific facts of the dispute. In addition, surety counsel should continue to argue for limitations of the surety's liability, based on the language of the performance bond in accordance with decisions such as the Florida Supreme Court's ruling in Larkin.